

February 7, 1989

Long-run Policy Alternatives Briefing  
Donald L. Kohn

I thought it might be useful to put today's decision about 1989 ranges in the context of the longer-term strategy for policy and how that relates to the FOMC's ultimate objectives. The presumption is that, in accord with both economic theory and a long history of statements by FOMC members, the primary objective of the central bank is to promote price stability. In fact "reasonable price stability" is a goal in the Humphrey-Hawkins Act, though it is subordinated there to achieving very low levels of unemployment. Emphasis on price stability as a policy objective has a number of beneficial effects. It provides a clear rationale for the conduct of policy, and a standard against which policy actions can be measured. When the rationale is backed by action, as in 1988, the result is enhanced credibility for the central bank, which may itself further the achievement of the objective. While the results of this credibility have been most transparent in prices of long-term credit and foreign exchange, it seems reasonable to think that reduced inflation expectations may also be affecting the pricing of output and labor at the margin.

It is tempting in this context to consider setting and announcing specific time tables for reducing inflation and achieving price stability as various Presidents and Governors have suggested. Two difficulties come to mind, however. One is that the Federal Reserve could not realistically be held accountable for a specific result on a year-by-year basis, given the multiplicity of imperfectly predictable factors outside its control

that affect near-term price movements. Divergences of results from targets could have adverse consequences for confidence. Moreover, the very long lags between central bank actions and effects on prices, together with the diverse nature of the other influences on prices make it impossible to establish in advance a simple, understandable guide to Federal Reserve reactions to misses from specific price objectives. If the public developed expectations of particular reactions, and they were not met, the credibility-generating benefits of the explicit target might be further eroded.

In the context of a general objective to restore price stability, the staff forecast, as Mike noted, assumed that the FOMC would act to put in place conditions that would lead to some reductions in inflation over time. In the staff's judgment, that requires additional restraint and higher real and nominal interest rates. Real rates have risen appreciably at the short end of the yield curve over much of the past year, as nominal rates increased while near-term inflation expectations showed little net change. And despite declines in nominal bond rates, real long-term rates may also have risen, judging from some survey evidence of reduced longer-term inflation expectations and perhaps also from the upward pressure on the dollar. But, given the evidence of underlying strength in demands on the economy and of greater wage and price pressures at current levels of resource utilization, these rates are seen as needing to rise further to foster even slow progress toward the ultimate objective.

The policy restraint assumed in the staff forecast implies the need for damped money growth in 1989--especially for M2, which is projected to grow 3-1/2 percent under this forecast. The slow growth in M2

is a result of the short-run interest sensitivity of this aggregate, which has been heightened of late by the especially sluggish movement of M2 offering rates. Even if deposit rates were not unusually slow to adjust, money growth would be quite depressed relative to income for several quarters in 1989, just from the effects of the tightening that has already occurred. With the slow deposit rate adjustment and the additional restraint under the staff forecast in 1989, a velocity increase in the order of 3-1/2 percent is expected this year, with both M2 and velocity essentially continuing on the paths established in the second half of 1988.

The effects of rising interest rates are considerably greater for M2 than M3, but growth of the latter is also expected to be quite damped, at 4-3/4 percent this year under the staff forecast. In part this is a feed-through of slow M2 growth and the tendency to replace a portion of the shortfall in retail deposits with managed liabilities outside M3. In addition, we have made some allowance for a less active thrift industry. In the case of M2, the thrift crisis and its resolution are expected to have only indirect effects, working through restraint on offering rates and higher opportunity costs, partly as a result of throttling back more aggressive thrifts. The underlying assumption is that any M2 deposits lost by thrifts because of uncertainties and lack of confidence would end up in banks. The impact on M3 is likely to be larger and more direct as insolvent thrifts are placed under closer control or closed, and tight growth restraints are placed on under-capitalized institutions. The mortgage credit these institutions would have extended is more likely to

be channelled to a variety of lenders through secondary markets, in effect reducing overall intermediation through depository institutions.

Despite the relatively slow money growth in the staff forecast for 1989, the effects on inflation are delayed and muted, even when the basic approach is extended to 1990 and 1991, as in strategy I in the blue-book, page 6, which is the baseline forecast used by Mike and Ted, Strategy II, which is keyed off one percent slower money growth, begins to make some progress in reducing inflation this year and leads to a full percentage point reduction by 1991. Nominal interest rates would rise by even more than under the staff forecast in the near-term, but would return to close to the strategy I path in 1990, given the resulting slowing of income and inflation and depressing effects on money demand. Real rates, however, would be higher over the forecast horizon to damp demand and relieve price pressures.

As Mike noted, these kinds of simulations shouldn't be taken too literally. The results, however, are suggestive of some aspects of the current situation, at least as embodied in the staff baseline and model structure. In particular, moderate monetary restraint as in the staff forecast or in strategy II, doesn't buy much in the way of lower inflation over the near term. Partly this is a function of the way in which policy works--affecting first the real economy and through that prices, given the stickiness of the wage and price setting process. In addition, the response of inflation to relatively small deviations of output from potential normally isn't very large. But, in the current situation the effect in terms of reducing inflation is delayed because of the starting point--that is, an economy that already may be running above levels of

resource utilization that seem to be consistent with holding, much less damping, inflation. In this circumstance, some restraint may be needed to stop inflation from accelerating even before it can be brought down, resulting in a interim period of slow growth, but still fairly high inflation. On the other side, there are no credibility bonuses built into the simulation. If still lower inflation expectations induced by policy tightening interact with greater price and wage flexibility than assumed in the exercise, perhaps in response to international competitive pressures, a more pronounced near-term disinflationary effect could occur.

Another aspect of the money paths in the strategies may have a bearing on the choice of ranges for 1989--that is the tendency for money to accelerate in 1990 and 1991. This results from a leveling out of nominal interest rates once the economy slows, and with that velocity, so that a pick up in money growth is not inconsistent with some continuing restraint on spending.

For 1989, two possible sets of ranges for the money and debt aggregates are given on page 9 of the bluebook. Both encompass the staff's expectations for these measures this year. Alternative I includes the ranges adopted in July on a tentative basis. They are a full percentage point lower for M2 than those for 1988, and 1/2 point lower for M3 and debt. Even so, staff expectations are for money growth well down in the lower halves of the ranges, especially for M2. As noted above, this is not just an artifact of the additional rate increases assumed in the staff forecast. Even if nominal GNP growth like that in the staff forecast were to occur while interest rate levels remained at current levels, M2 still would be likely to grow in the lower half of its range. This leaves

limited scope at the lower end of the range for a tighter policy than in the staff forecast, should inflation pressures be more intense or prompter progress on this front be desired. And at its upper end, 7 percent M2 growth this year implies room for, and possible tolerance of, a substantial pick up from 1987 and 1988 at a time when an important concern would seem to be constraining nominal expansion to limit price pressures.

In these circumstances, lower growth ranges, like those in alternative II might be considered. The principal drawback would seem to be found in consideration of how ranges should be formulated over a series of years. As noted in the various strategies, a pick up in money growth in coming years may be appropriate as inflation levels out or moderates. In that case, if the ranges are reduced rapidly at this time they might have to be raised later or exceeded. More limited reductions now will make future decreases, for example in 1990, a more reasonable prospect in a long-term process of reducing the ranges toward levels consistent with price stability. If alternative I ranges are reaffirmed, the Committee might want to consider whether to inform Congress that money growth might be in the lower halves of the ranges; that might be explained as an aspect of "erring on the side of restraint", both as it already occurred in 1988 given the lagged effect on money growth, and prospectively in 1989.

Both alternatives include ranges that continue the 4 percentage point width now in use. The rationale for this wider range was never very clear with respect to M3 and credit. Even for M2, many of the questions last February about appropriate growth in 1988 had to do with particular uncertainties in the wake of the stock market collapse. Unusual uncertainties as we begin in 1989 seem more centered on the financial sector in

the form of thrift difficulties and of the course of leveraged corporate restructuring activity, which would affect mainly M3 and debt; doubts about which way the economy and interest rates will go seem no more imponderable than usual, though M2 demand may be especially interest sensitive if deposit rate adjustments remain sluggish. If there were some interest in narrowing the ranges, while at the same time reinforcing the message of determination to lean against inflation, shaving an additional 1/2 percentage point off of the upper ends of the ranges might be considered.

Finally, in the draft directive, language has been retained to say that again no range has been established for M1. Some modifications also are suggested should the Committee wish to indicate that movements in all the aggregates--not just M1--will be evaluated in light of other indicators of the effect of policy on the economy. In many respects this would be consistent with the Chairman's last two Humphrey-Hawkins testimonies, and also with the operational paragraph of the directive. On the other hand, there is a better case to be made for the aggregates as long-run policy guides than as constraints on intermeeting reserve adjustments.

February 8, 1989

Short-run Alternatives Briefing  
Donald L. Kohn

The near-term operational question for committee consideration at this time appears to be whether to tighten further, and if so by how much--at least this is what we presumed when we omitted alternative A from the bluebook. As a number of members have already mentioned, the recent behavior of several financial market indicators may have a bearing on this decision. These include the yield curve, the dollar, and the money supply.

The yield curve has flattened further over the intermeeting period, looking from the very short to the long end of the maturity spectrum. Yet it does retain an upward slope out to 2 years or so--suggesting that some further rise in short-term rates still is expected. As Peter noted yesterday, in the wake of the employment data and against the background of the Chairman's recent testimony on seeking price stability, an immediate rise of the federal funds rate to the 9-1/4 to 9-3/8 area now is widely anticipated. The shape of the curve and the positive response to the testimony in the long-term markets suggest that market participants have increased confidence that the Federal Reserve has taken and will continue to take the actions needed to keep inflation from accelerating. They do not yet think that it will be reduced, however, judging from the level of the long-term rate, which at 8.80 percent would seem to have inflation expectations of 4 to 5 percent built in.

Whether another tightening is needed is a separate question from whether it is expected, though disappointing such expectations may



have some repercussions that themselves should be taken into account. The staff forecast of course saw a need for a bias towards tightening over the year, but that forecast was not dependent on specific actions taken at this meeting. The rise in real interest rates that has already occurred from our tightening actions should be damping demand to some extent over coming quarters. This restraint probably is being felt in long- as well as short-term rates, despite the drop in nominal bond yields. Long-term inflation expectations have fallen, and the lack of corporate bond issuance may reflect in part a sense that these rates are high, at least relative to expected returns on capital. Real rates are impossible to measure with any confidence, but using a variety of techniques it would appear that they are probably in the neighborhood of 4 percent. This is well above the levels prevailing in 1986 and 1987, which contributed to the strong growth in 1987 and 1988, but it is below those earlier in the expansion. Thus, real rates would seem to be in a somewhat ambiguous zone with respect to whether they are high enough to restrain incipient price pressures.

The rise in real rates and confidence in the Federal Reserve has been mirrored in a stronger dollar. A rising dollar is uncomfortable for a country that views its external deficit as resulting more from previous dollar overvaluation than from excess demand and price pressures. There is a little irony in the circumstance in which a dilemma for the monetary authority is created by its own enhanced credibility. In the absence of a more appropriate macro policy mix U.S. authorities have attempted, together with our trading partners, in effect to limit the external effects of our tighter monetary policy by

intervening in exchange markets. If successful for any length of time, which is a proposition most of us doubt, such a combination of policies would circumscribe an important channel through which policy can damp activity and price pressures, but it would keep the impact of tighter policy focussed more on US domestic demand. Another firming at this time would add to the difficulties of keeping the dollar down, but it would not necessarily invalidate the basic strategy of using both policy tools. Given the uncertain prospects for fiscal policy, monetary policy alone may not be able to foster both internal and external balance in the current circumstances. The policy decision probably should continue to rest primarily on the evaluation of what stance is needed for internal balance, but this decision must take account of the effect of dollar strength on activity and prices in the U.S.

Finally, there is the very sluggish behavior of the money supply of late. This is largely a response to the previous tightening, and to the extent that this tightening is seen as having been appropriate, so also would be the slow money growth. Our money demand models suggest that the accumulated effects of previous interest rate increases are shaving as much as 4-1/2 percentage points from first quarter growth of M2, which we are projecting at around a 3 percent annual rate on a quarterly average basis. The actual effects of interest rate increases are probably a little larger since the models don't take account of the unusually slow adjustment of offering rates. The staff projects a small strengthening in M2 growth under the constant interest rates of alternative B, to about 3 percent over February and March, and a continuation of the average growth of December and January under alternative C. I

might note that if money comes in at near these rates it would be near the model forecast, given the greenbook spending projection for the first quarter suggesting that such an outcome is not inconsistent with fairly robust expansion of income.

Whatever course the Committee chooses for policy, there is the recurring problem of the borrowing/federal funds rate relationship. In the bluebook we posit that \$600 million of borrowing will be consistent with federal funds around or a bit above 9 percent, but we freely admit our uncertainty. As Peter noted, recent borrowing has been running well below this level at prevailing funds rates. We think this may be due to a seasonal low point for borrowing in January and early February, reflecting perhaps the usual trough of seasonal borrowing as well as the after effects on adjustment borrowing of discount window maneuvering around year-end. Our assessment of the borrowing/funds rate relations under the two alternatives embodies a belief that borrowing will bounce back seasonally, as it has for the past several years, lining up better with the borrowing relation as it developed last fall. If we are wrong and something more fundamental is occurring, lower borrowing will be required to keep funds in the neighborhood of expected levels. In these circumstances, continued flexibility in desk operations vis-a-vis borrowing objectives may be a sensible option.